Some Notable Frauds in Accounts.

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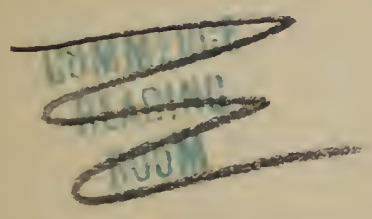

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SOME NOTABLE FRAUDS IN ACCOUNTS.

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§ 1.—The Investigation of Fraud.

MANY valuable lessons may be learned from an examination of the origin of frauds, the means by which they were practised, the methods by which they were detected, and the measures which may be taken to prevent the possibility of their recurrence.

There is an element of romance in every fraud, for the successful perpetration of which skill is required. There is frequently an element of comedy ; there is almost always an element of tragedy—the ruin of some career, whether brilliant or obscure, not seldom accompanied by the self-infliction of the ultimate penalty. In every case, whether large or small, the human element predominates, and those who have had any experience in investigating frauds, and who have been brought into touch with the criminal, and perhaps cross-examined him on the origin and methods of his crime, will know that such affairs, though of the most intense interest, are frequently of the most painful nature, and call for the most sympathetic and tactful treatment.

The Professional Accountant who does not happen to be personally compromised, perhaps by reason of the possibility of a claim being made against himself in respect of negligence, alleged or otherwise, can enter upon the investigation of fraud in a spirit of impartiality. He is not blinded by the almost insane fury which frequently possesses those who have been the victims of the fraud, and who may have suffered heavy pecuniary losses thereby ; neither is he in the position of a Judge, who, as the accredited representative

of public order, is compelled to pass sentence upon the criminal. He is merely an expert called in for the purpose of discovering the extent of the deficiency, the methods practised by the guilty party, and the originating cause or causes which enabled such manipulation to be possible. Frequently also he is asked to suggest such a system of checks and counter-checks as shall prevent the reasonable possibility of the recurrence of the same or similar malpractices.

In cases where the defaulter has not absconded, and where he can be cross-examined, by the exercise of personal tact in handling him, and by the display to a reasonable and legitimate extent of that sympathy which every humane man must feel for the criminal in the terrible position in which he finds himself, valuable information may frequently be obtained, which will throw light on the technical aspects of the matter, which would not have been obtained had a harsh and bullying attitude been taken up in the attempt to get information.

It will not be questioned by any having experience in these matters that the great majority of frauds are discovered and dealt with without the institution of a prosecution. In the minds of many humane persons there is a profound aversion to taking any steps which may bear the interpretation of personal revenge, and which would have the effect of ruining the career of the man who has succumbed to temptation, the strength of which was perhaps greater than his nature could withstand, without any corresponding advantage resulting therefrom. There is, of course, another side to the case, and the question as to whether it is not in the interests of the public that the criminal should be awarded his just punishment is one of great importance, which should not be underrated, but which must be left to the judgment of those immediately concerned, having regard to all the circumstances ; but the fact remains that in a very large number of cases prosecutions are not instituted, either for the reason already indicated, or, as in other cases, because of the cost of instituting proceedings, and the waste of time and trouble involved thereby.

For the purpose of this Paper three frauds, and three only, have been selected, but they are each of great magnitude, and without question are the biggest perpetrated within recent years.

The *Millwall Docks* case involved no less a sum than £239,049. The defalcations at the *Bank of Liverpool* extended to £170,000, although a large portion of this was ultimately recovered; while the case of the *London and Globe Finance Corporation, Ltd.*, and its kindred companies, involved a loss to shareholders of £5,000,000, and to creditors of nearly £3,000,000, though the loss itself in this instance cannot be called fraudulent, but rather the manner of concealing it from the shareholders and the public.

Frauds on such a scale are fortunately rare; but history repeats itself, and human nature is a very constant factor, so that notwithstanding the lessons they teach, and the more scientific systems of accounting at present in force, frauds of great magnitude will no doubt from time to time arise. Such frauds are usually based on the extension of principles that operate in those of a smaller scale, and the difference is generally found to reside in the audacity and resource, in some cases amounting almost to genius, of the operator.

The very magnitude of the scale employed throws into high relief the methods adopted, and intensifies the interest aroused, and it is hoped that the morals which it is proposed to draw from the consideration of these notable cases will be found applicable from a general point of view.

§ 2.—The Millwall Dock Case.

The fraud in this case was remarkable, inasmuch as the party at whose instance it was perpetrated did not himself benefit, except to a very slight extent, from the cash point of view, and the fraud did not take place with that object.

Mr. Birt had been manager of the company for twenty-five years, and was then appointed managing director, with a seat on the board. He had occupied this position for five and a half years when the discovery was made of the falsification by him of the accounts.

When the accounts for the half-year ending 31st December, 1898, were submitted to the board on 6th February, 1899, Birt was absent through illness, and the board resolved on a thorough investigation into the item "Import and Export Rates and Rents on Goods and Shipping due to the Company." This item had shown a continuous increase for many years, as will be seen from the following figures :—

	£	s.	d.
On 31st December, 1870	22,280	0	0
,, ,, 1880	65,683	0	0
,, ,, 1890	143,067	0	0
,, ,, 1893	173,930	0	0
,, 30th June, 1898	232,363	0	0

Questions had been asked Birt from time to time as to the cause of the increase, but he had always been able to explain it to the satisfaction of the directors. On Birt's return to the office the resolution of the board was communicated to him, and he thereupon absconded.

Only the general accounts of the company were kept at the City office, the detail accounts being kept at the docks by a separate staff. Birt divided his time between the two offices, and so was equally cognisant of the transactions carried on at both. The other directors probably confined their attention to the City office, and, not being dock experts, were more or less in the hands of Birt on technical points.

Every half-year the results of the trading in different departments were worked out, and for this purpose every item was taken out of the Ledgers on to sheets, from which they were posted into Revenue books, showing in one column the rent accrued on each parcel, and in another the sundry charges and payments outstanding due, or estimated to have accrued, in respect of each parcel.

It was in the latter column that the falsifications occurred, the sundry charges outstanding being calculated on rates which Birt directed. He sent down private orders to the indoor super-

intendent as to these rates, which were progressively exaggerated from half-year to half-year.

The detail accounts were contained in more than 200 Ledgers, involving 12,000 accounts ; and the Revenue book of each department, when it was handed to the Auditors, was certified by the indoor superintendent of the docks, the chief clerk at the docks, and the principal Ledger clerk of the department concerned. The Auditors cast these books, and thus verified arithmetically the summarised statement of their contents, which was signed by the indoor superintendent and Birt, the managing director.

The fraud therefore involved the collusion of four responsible officials.

As a result of a detailed investigation carried out by the order of a shareholders' investigation committee, it was found that the total deficiency involved amounted to £239,049, of which the manipulation of the outstandings account for £206,754, while fictitious Journal entries represented the balance, one of which was itself responsible for an error of £10,345.

In the course of his trial Birt contended that he alone was responsible for the system, which had been adopted without any intention on his part to defraud, but was carried out for the purpose of inspiring the shipping interest with confidence in the ability of the Dock Company to do its work. Prior to the Company being a Dock Company it had been a Land Company, and Birt contended that, as the value of the land had considerably increased during the period, all he had done was to put the earnings of the docks and land into one item, and that therefore no actual payment of dividends out of capital had occurred.

Apart altogether from the question as to whether the land had increased in value to the extent of the deficiency, it is obvious that this defence was an extremely weak one, and merely put forward as an excuse, since this point of view was taken without consulting or informing either the directors or the Auditors. Moreover, in any case the profit would have been an unrealised one, as the land had not been sold.

As regards Birt's contention that he did not personally profit by the manipulation, it may be said that during the time he was manager he received a salary of £500 per annum, and a commission of 2 per cent. on the profits. After he became managing director he received a salary of £2,000 and no commission. While receiving commission he took about £1,800 more than he was entitled to on the manipulation of profits. As a result of the trial he was sentenced to nine months' hard labour.

It is apparent that had any one of the principal items of these outstandings been tested by the Auditors, with actual evidence, showing how the amount was arrived at, the fraud would have been discovered, since the increase was automatic in respect of every item. This, however, was never done, and the Auditors were content to cast the Revenue books and accept the certificates of the four officials.

It is true that they asked for explanations from time to time, as to the increase in the value of these items, but since all the prominent officials were in collusion they received the same explanation from each in turn, which would seem, in the absence of suspicion, to be very corroborative evidence. The fact remains, however, that a very small amount of testing would have discovered the over-valuation, and this would have been quite possible, although the time at the disposal of the Auditors for the purpose of the audit was extremely short, being, in fact, less than a week.

There can be no question that where the amount of detail is so large as to render any exhaustive check impracticable, it is quite possible for a careful test to be made which, at any rate, will disclose whether or not a systematic manipulation is being practised. Such testing will naturally not disclose isolated instances, and the discovery of such must depend on the efficiency of the internal check in operation. The internal check in this case would at first sight seem to be adequate, since four officials were involved ; at the same time, it must be borne in mind that Birt, the managing director, was absolute master of the Company, and could order his subordinates to do whatever he chose. Possibly they were

not entirely cognisant of the results of the instructions that he issued. In any case they may have been afraid to report the matter to other directors, for fear that they would lose their positions.

The case as a whole illustrates the danger of placing one man in supreme control, his colleagues on the board being merely men of business, and unacquainted with the technical details of the concern. If such a situation cannot be avoided, steps should at least be taken to avoid the possibility of a wholesale hoodwinking of the board and the Auditors by the managing director in control.

§ 3.—The Bank of Liverpool Case.

The fraud perpetrated on the Bank of Liverpool by one of their clerks named Goudie, which ultimately involved the enormous sum of no less than £170,000, affords one of the most notable illustrations of the risks to which a bank is subject if its system of internal check is not a proper one, or, being a proper one, is not rigorously carried out.

Goudie was a Ledger clerk in the employ of the bank, earning £150 a year. In 1899, having become addicted to horse racing, and incurred losses, he found himself in difficulties. At that time he was in charge of the Ledgers H to K inclusive, and was responsible for the writing up of the accounts therein. Mr. R. W. Hudson's private account was in his charge. He had noticed that Mr. Hudson had been in the habit of drawing small cheques in favour of Mr. Style, and, having obtained a blank cheque from a clerk at the bank on the payment of one penny, he drew a cheque for £100 in favour of Jane Style, and forged Mr. Hudson's signature to it. He then went to the branch office of the North and South Wales Bank in Liverpool, showed the manager there the cheque, told him that the payee was his mother, who had a banking account at one of their branches, asked him to collect the cheque, which was done, and on 18th November the money was paid over to him at the counter. This operation having proved successful, on December 5th he drew another cheque for £100

in the same manner, and took it to another bank, asking them to collect the cheque for him, which they did, and the money was paid over the counter to him.

As soon as these cheques came on to him after being cleared he made no entries in the Ledgers, but put the cheques in his pocket, and ticked off the clearing books. To square the balance on 31st December, 1899, of the £200, he made one fictitious entry, and debited that amount to another Ledger account, reversing the entry on 2nd January, 1900, by making a bogus transfer, and crediting that account with £200. In the Journal he caused to be debited some other account with the amount, but did not make any entry in the Ledger. During the succeeding half-year he continued operations in the same manner, and on 30th June, 1900, the debits in the Journal were in excess of debits in the Ledger to the extent of £1,500. This he concealed by debiting H. Bros. Suspense Account, reversing the entry on July 3rd following.

During the following half-year he continued his defalcations on an increasing scale, and on the 31st December, 1900, the amount involved was £9,504 10s. 0d. This deficit was concealed by a fictitious entry made by him in H. Bros. Suspense Account for £9,000 14s. 4d., such entry being reversed on January 1st. The balance of £503 15s. 8d. was concealed by a fictitious entry made in another account, and reversed on January 1st. There were also fictitious entries for interest regarding these amounts.

Having succeeded beyond his expectations in concealing his traces, and having fallen into the hands of a couple of racecourse scoundrels who effectually worked together to defraud him, and who were aware of his exceptional means of access to money, Goudie continued transactions on a still larger scale, in the hope of recovering his previous losses, and on 30th June, 1901, the deficit at the bank was £43,504 10s. 0d. This was concealed by a fictitious debit entry made by him in another account. The correct balance of this account was, after audit, brought forward by him into the new half-year. Before the fictitious entry was

made, he extracted the balances on to the half-yearly sheets, and made the balances on the sheets less by £43,504 10s. 0d. than the Ledger. The Ledger being correct, the Pass book was written up by another clerk. After the Pass book was written up Goudie got hold of it. During the checking of the balances he got hold of the half-yearly sheets, and ticked off the Ledger Account against the Pass book, and initialled the Pass book. Subsequently he altered the Ledger so as to make it agree with the half-yearly sheets.

During the succeeding months, having become further involved with another set of scoundrels, the defalcations continued to increase, until by November, 1901, they had reached £170,000.

At this moment the fraud was discovered, but the discovery was not due to the operation of any form of internal check, but was occasioned by the action of a clerk in Lloyds Bank, London, who had to deal with one of the incriminating cheques. As he thought appearances suspicious, he consulted his superiors, who communicated with the Bank of Liverpool. The manager of the latter bank asked for an explanation from Goudie, who said, "Oh, yes, I will fetch the papers." He immediately left the bank without his hat, and disappeared. He was arrested a few days afterwards, and as a result of the subsequent trial was sentenced to ten years' penal servitude, corresponding sentences being passed on his associates.

The chairman of the bank stated that the system of internal check had been in operation for forty years, and they had always found it satisfactory, and that the reason why the fraud was not discovered was that it was unique, inasmuch as Goudie had access to neither cash nor securities, and that he was in league with parties outside the bank, and was in addition a skilful forger. Notwithstanding these explanations, the idea that the internal check in operation was a proper one, seems to be rather difficult to reconcile with the facts of the case.

Apparently it was the custom of the bank to leave each Ledger clerk in charge of the same Ledgers, and not to change about.

Goudie also appears to have taken part in the checking of his own Ledger with the Clearing House Journal, &c., which enabled him to omit posting the forged cheques (which cheques he afterwards destroyed), and he manipulated the accounts in such a manner as to temporarily charge same to other customers' accounts in the Ledger when balancing time came, and then reverse these entries at the commencement of the new year by bogus transfers.

He forged the initials of the Professional Auditors' clerk in the Pass books of those customers to whom cheques were temporarily debited, and had the Pass book passed out so that they did not come before the Company's Auditors. The bank inspector, seeing they were initialled, concluded that the Auditors had passed them, and did not check them again. These Pass books seem to have been written up by another clerk from the Ledger before the false entries were made, and so were correct.

Looking at the matter from the Professional Auditor's point of view, the question may well be asked, How was it that these frauds were not discovered, although they affected no less than four successive half-years' balances? And the reply seems to be that the Balance Sheet of the bank agreed with the books, but that the entries in the Customers' Ledger were fraudulent; and the Pass books, which would have disclosed the difference, were purposely kept out of the Auditors' reach, and in some cases the initials of the Auditors were forged thereto. Unless, therefore, it is maintained that it is the duty of the Auditors to verify in detail transactions in the current accounts, they could not have been expected to discover the fraud.

From the bank's point of view in relation to their system of internal check, there can be no such justification, and if a proper system had been in vogue, and rigorously enforced, the frauds would have been discovered at a very early date, if, indeed, they had ever taken place at all.

In the light of this case the following checks, or their equivalents, would seem to be essential:—

(1) The Ledger clerks should be changed about from time to time without previous notice.

(2) Each clerk should be required to take his annual holiday, and to take it at one time without a break.

(3) The cashiers should not be permitted to make entries in the customers' Ledgers.

(4) The Ledger clerks should have no access to the Cash book or the Clearing House Journal.

(5) The Cash book should from time to time be compared with the actual records by independent and responsible officials, and subsequently with the Ledgers.

(6) No Ledger keeper should be a party to testing his own work.

(7) The periodical balancing of customers' accounts with the General Ledger should be performed by independent officers selected by the Accountant.

(8) At intervals the testing of the Ledgers should include the "sides" of the accounts in addition to the extended balances, thus affording a comparative check with the Total Summation book to which the aggregates of payments and cheques are posted day by day.

(9) The branches should be subject to frequent audits, without notice, by Travelling Auditors or inspectors.

(10) An occasional audit by the bank's inspector should be in force in respect of the head office, in the same manner as the branches.

(11) Neither Cashiers nor Ledger keepers should participate in the preparation or checking of bank Pass books, and such bank Pass books should be checked by the bank's officials, independently of the Company's Auditors.

(12) Ledger clerks should have no access to cancelled cheques where the same are not returned to the customers.

Had the principal of these suggestions been in operation, there can be no question that the fraud would have been discovered in its early stages.

There can be no doubt that the defalcations were facilitated by the apparent ease with which Goudie was able to obtain blank

cheques on payment for the stamp, without having an account at the bank in question, and by the facility with which he was able to induce the managers of other banks to collect cheques for him without having an account in the first instance with them. It was not the custom of this bank to return customers' cheques, and Goudie was in the habit of taking R. W. Hudson's cheques home with him for the purpose of practising the signature.

§ 4.—The London and Globe Finance Corporation Case.

Quite the most notable case of fraud in connection with finance companies arose in the case of the *London and Globe Finance Corporation, Ltd.*

This Company was formed, according to its Memorandum of Association, to engage in "all kinds of financial operations," and it must be said that this promise, in the light of subsequent events, was more than fulfilled, since some of the operations were of the most extraordinary nature.

The Company was an amalgamation of two previously existing Companies—the West Australian Exploration Finance Corporation, with a capital of £195,000 in ordinary shares and £5,000 in deferred shares, formed to develop and deal in mine properties; and the London and Globe Finance Corporation (old Company), with a similar capital.

The new Company formed to take over these two Companies issued paid-up shares of £1,600,000 in exchange for shares of £400,000 of which £990,000 were issued to the ordinary shareholders against £390,000 held by them, and £610,000 were issued to the holders of deferred shares for £10,000.

These deferred shares had been issued to Mr. Whitaker Wright, the promoter of the two Companies; in the one case in consideration of certain options to acquire mining interests, &c., and in the other case in consideration of promotion services.

After two years' operations these deferred shares for £10,000 were converted into ordinary shares to the extent of £610,000, no less than sixty-one times their nominal amount, while the ordinary

shares themselves were converted into new shares to the extent of nearly three times the nominal amount.

The Directors of the London and Globe left the entire control of the financial operations in the hands of Mr. Whitaker Wright, the Managing Director, who entered on an extensive promotion of new Companies, and conducted a series of gigantic operations on the Stock Exchange. As an illustration of the transactions entered into, the Company promoted the British America Corporation, Ltd., receiving £500,000 in paid-up shares and certain rights which the London and Globe Company had agreed to purchase for £100,000 in paid-up shares thirteen days previous to the incorporation of the British America Company. As a result of this operation, credit was taken in the books of the London and Globe Company for a profit of £400,000, less £50,000 paid as the cost of underwriting and subscription. The property thus transferred to the British America Company simply consisted of options to acquire certain interests, and no actual property was sold.

Subsequently the Standard Exploration Company was formed, with a similar capital, merely for the purpose of being utilised as an adjunct in the financial manipulations. Mr. Wright was the Managing Director of all three Companies, and had complete control. Although there was a Board of Directors, Mr. Wright was the moving spirit in all the transactions, and the Board merely constituted a machine to register resolutions which Mr. Wright desired them to pass.

In these three Companies capital to the extent of £5,000,000 was lost, and liabilities to creditors were incurred to the extent of something like £3,000,000, in respect of which the return was very small.

On 15th December, 1900, a Balance Sheet was sent out by the London and Globe to its Shareholders, made up to the 8th of that month. The Shareholders' Meeting was held on the 17th, and on December 28th the London and Globe announced that it had to suspend payment. The next day a meeting was held and a resolution passed to wind up voluntarily. Early in 1901, however, the winding-

up was made under the supervision of the Court, and in October of that year the order was made compulsory.

Very heavy speculation had been taking place on the part of the London and Globe and its kindred Companies in Lake View shares, and the failure of the Company was in the first instance directly due to the failure of that particular gamble. Enormous liabilities to Brokers were involved, and as a result a considerable number of Brokers failed, and there was something approaching a panic on the Stock Exchange. Attempts were made to induce the Public Prosecutor to prosecute Mr. Whitaker Wright, on the grounds of issuing fraudulent Balance Sheets, but that official declined to take up the matter, and it was only in 1903 that, at the instance of shareholders and creditors, the prosecution was instituted against Mr. Whitaker Wright, the trial taking place in February 1904. Proceedings were taken under the Larceny Act of 1861, on the ground that Whitaker Wright had knowingly made false statements in writing with the intention of deceiving or defrauding shareholders or creditors, or persons who might be induced to become such.

There were no fewer than twenty-six counts in the indictment relating particularly to the Balance Sheets issued by the Corporation dated 30th September, 1899, and 7th December, 1900, and the reports issued with those Balance Sheets. After a trial lasting several days the defendant was found guilty on all counts, and sentenced to seven years' penal servitude, the maximum penalty under the Act.

The tragic and unexpected manner in which Mr. Whitaker Wright defeated the ends of justice by taking his own life in Court immediately after the sentence was pronounced, and the sensation that it caused, will be remembered by many.

It is proposed now to summarise, from the somewhat difficult tangle of evidence, the leading charges in the case.

The Balance Sheet of 1899 showed cash at Bankers £534,000, and in the report Mr. Whitaker Wright stated that this represented realised profit. As a matter of fact, this statement was wholly

untrue; the cash balance was arrived at on the 30th September by a series of manipulations with kindred Companies.

On 29th September the London and Globe purported to sell shares to the Standard Company for £158,000. Mr. Wright signed the cheque for the one company to go to the other. No minute was passed, and there was no resolution of the board, Other transactions of a similar nature took place, and of the cash of £534,000 mentioned above, the Standard Company found no less than £359,000. The money was obtained by that company by another series of extraordinary manipulations and loans, but as the companies did not issue Balance Sheets made up to the same date, these transactions could, after the issue of the London and Globe Balance Sheet, be carried out in an opposite direction, so as to place matters as they were previously in time for the issue of the Standard Balance Sheet. While the cash balance on 30th September showed at £534,000, on September 27 it was only £29,300, and on October 24, the date of the shareholders' meeting, the cash balance had been reduced to £56,000.

The Balance Sheet of 1900 should have been issued made up to 30th September, since that was the date of the previous Balance Sheet. This, however, would not have been at all convenient, because had accounts been drawn at that date a loss would have been shown of no less than £1,600,000. As a disclosure like this would have inevitably brought the company down, it was decided to make the Balance Sheet up to 8th December, 1900, and the period between 30th September and that date was occupied by ingenious manipulations, so that when the accounts were issued, instead of a loss of £1,600,000 appearing, a profit was shown of £463,000.

In the Balance Sheet the item "Shares in other Companies" appeared at £2,332,632 0s. 1d. As the counsel for the prosecution said, the penny was almost artistic.

These shares were represented as being valued by the directors, and the basis of valuation was sometimes cost and sometimes par.

The Standard shares were taken into the Balance Sheet at 20s. 3d., but at the date they were being sold at 10s. Although the

market price in these cases is not by any means a real criterion, since that price itself may have been caused by rigging the market, at the same time it is some standard to go by. If those shares that were actually quoted on the market had been taken at their market price, and those not quoted had been taken at par (which in itself is generally an absurd valuation in these cases), there would still have been an over-estimate to the extent of £750,000. It was contended, therefore, that the estimate placed by Whitaker Wright on the value of these shares was false to his knowledge.

At the date of the Balance Sheet there were heavy speculative transactions open on the Stock Exchange, principally in Lake View shares, involving liabilities of £1,600,000. It was inconvenient to show on the Balance Sheet that there were these liabilities to stockbrokers, and that there were shares to that extent to take from them. The amounts therefore were eliminated from the Balance Sheet and no reference made to the facts of the case. This liability was purported to be got rid of by a series of resolutions signed by two directors on loose sheets of paper, transferring the liability from the London and Globe to the Standard Company; but this arrangement was quite invalid, as it was not possible by any resolution of either company to transfer the liabilities to brokers from one company to the other.

There were a large number of other transactions of a complicated nature which might have been dealt with, but sufficient has been said to illustrate the methods which were adopted to manipulate the Balance Sheets for the purpose of deceiving the shareholders and the public. It may be useful now to summarise those methods, and to make some comment upon them.

There is in the first instance the manipulation of the cash balance in the Balance Sheet of 1899, until it reached the sum of £534,000; and this balance, which has been hurriedly brought together as the result of transactions a few days prior to the Balance Sheet, is represented in the report of the directors to the shareholders as due to the operations of the directors extending over twelve months, to strengthen and maintain the position of the

company during the past year, and, further, as representing realised profit; when as a matter of fact it had nothing to do with the operations of the past year, and did not represent realised profit.

This may be said to be a flagrant illustration of "window dressing" in its worst form. To a certain extent bankers and financial companies are in the habit of calling in loans prior to the date of the Balance Sheet, in order to show an increased cash balance, and to illustrate the fact that their assets are in liquid condition; and as long as this is a genuine realisation of a genuine asset, nothing can be said against it. In the case under consideration, however, cash was accumulated, not by genuine realisation of assets, but by fictitious sales of shares, which were bought back again immediately after the date of the Balance Sheet, as soon as the cash consideration had served its turn by appearing in the Balance Sheet as a cash balance.

In the same way money was borrowed for a few days prior to the date of the Balance Sheet, and paid back immediately afterwards, the money being borrowed for no other reason than to swell the cash balance. It is true that corresponding liabilities were created, but the value of the cash balance from the point of view of the shareholders' meeting far outweighed the disadvantage of a corresponding increase in liability.

The effect of a manipulation of this sort is not to make the Balance Sheet actually incorrect, since it will as a fact represent the position of affairs at the date in question; but when the motive underlying the manipulation is considered, viz., the intent to deceive shareholders and the public by showing a Balance Sheet which would seem to suggest that the company is in a much stronger position than it really is—the result is in effect a fraudulent Balance Sheet.

In such cases the duty of the Auditor is a somewhat difficult one. The Balance Sheet may be technically correct, but if the Auditor is convinced by the evidence he has been able to obtain that the cash balance has been deliberately manipulated for the purposes of the Balance Sheet, that Balance Sheet cannot be said

to represent a true and correct view of the state of the company's affairs in principle, although it may be so technically. The determining question is—Are these operations conducted for the general purposes of the Company, and in the legitimate course of business; or are they specifically entered into for a temporary object, that object being to enable a Balance Sheet to be produced which shall make the position look better than it really is? In the latter case there can be no question that it is the Auditor's duty, if he is aware of the facts, to report his opinion on them to the shareholders.

The principal method utilised for the purpose of inflating the profits was to treat the shares received on promotion of subsidiary companies as worth par, instead of bringing them in at the original cost of the asset sold, and taking profit only if and when the shares are realised at any price above such cost.

This principle can be illustrated very simply. A company possesses property which cost £5,000. It sells this property to another company for £50,000, payable as to £2,000 in cash and £48,000 in fully-paid shares. The proper method of treating this transaction is to set off the cash received as against the cash paid, leaving a debit balance on the Property Account of £3,000. The 48,000 shares should then be brought into the books at a value of £3,000. When any of these shares are sold at a price above that valuation, the resulting profit is a realised cash profit, and can be treated accordingly.

The method adopted by the London and Globe, however, was to treat the 48,000 shares as being worth £48,000, thus showing a profit on the promotion of £45,000, which in due course was placed to the credit of Profit and Loss. The shares acquired appear on the Balance Sheet at par, and although a reserve may be made against that value, the ultimate result is to falsify the position. Until the shares are sold all that has occurred is the exchange of property which stood at £5,000 for £2,000 cash and £48,000 of shares, and the cost of these shares therefore is no more and no less than £3,000.

The par value in most cases is entirely fictitious, and the same can be said to a large extent of the market value, since in these cases that is only usually obtained by rigging the market, and if any large block of shares were put on for sale the price would rapidly crumble away.

It may be said that in Companies of this sort these shares are analogous to stock, but even if this were so that is no reason why the rule universally applied to stock of valuing at cost or market price, whichever is lower, should be departed from.

A further ingenious delevopment of this paper profit principle was applied in the *London and Globe* case, which may be illustrated as follows :—Assume that property originally costing the A Company £5,000 is sold to the B Company for £50,000 in cash and shares, the A Company taking £45,000 profit on the transaction, and that in the course of a few months the B Company sells the same property to the C Company for £200,000 in shares, such shares being allotted to the Shareholders of the B Company, which is forthwith wound up, the holders of the shares in the B Company receiving four shares in the C Company for each original share held by them. The A Company, having held 48,000 of such shares, receives 192,000 shares in the C Company, and makes a paper profit on the transaction of £144,000. By this arrangement it will be seen that the A Company makes, by selling a property costing £5,000 to the B Company, a profit of £45,000, and by the B Company selling the same property to the C Company a further profit of £144,000, making altogether a profit of £189,000, which is entirely fictitious, since the asset in respect of which this profit is presumed to have been made remains in exactly the same condition, and the consideration received has not been realised.

The third method adopted by the London and Globe Company to misrepresent the state of affairs was to transfer liabilities of £1,600,000 to Brokers in connection with transactions open on the Stock Exchange from their own Company to a subsidiary Company by means of Resolutions on loose sheets of paper, passed after the date of the Balance Sheet, and without the consent being

obtained of the creditors themselves. Such a proceeding, of course, was wholly invalid, and would be open to the gravest objection, even if the consent of all the parties had been obtained.

Looking at the case generally, it forms a signal illustration of the malpractices that may arise when an unscrupulous Managing Director is in control of a group of Companies, whose offices are in the same building, whose Boards are entirely under the influence of the Managing Director and resolve themselves into machines for registering his decrees, and whose Balance Sheets are issued on different dates, thus affording the means of adjustment between one Company and the other for the purpose of window-dressing each Balance Sheet in turn.

§ 5.—The Liability of Auditors.

The examination of the three cases selected has now been completed, but before concluding it may be useful to indicate the legal liability of Auditors in analogous circumstances.

As regards the first case, where the Auditors accepted the certificates of responsible officials as to the extent of the outstandings, the remarks made by Lord Justice Lopes in the course of his judgment in the case of the *Kingston Cotton Mill Co., Ltd.* (No. 2, 1896, 1 Ch. 331) are pertinent. He then said :—

" It is the duty of an Auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious Auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An Auditor is not bound to be a detective or, as was said, to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watch dog but not a bloodhound. He is justified in believing tried servants of the Company, in whom confidence is placed by the Company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonably cautious and careful . . . . The duties of Auditors must not be rendered too onerous. Their work is responsible and laborious and the remuneration moderate. . . . Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds

are perpetrated by tried servants of the Company, and are undetected for years by the Directors. So to hold would make the position of an Auditor intolerable."

The limitation of the Auditor's liability as laid down in this case by the Court of Appeal has recently been followed by Alverstone C. J. in *Henry Squire, Cash Chemist, Ltd.*, v. *Ball Baker & Co.* (1911, 44, Acct. L.R. 25), when the learned judge remarked with reference to the judgments in the *Kingston Cotton Mill* case :—

"I understand them to lay down this rule that the Auditor is not bound to take Stock; that the highest which can be put against an Auditor or Accountant in the one case or the other is that he is bound to make a reasonable and proper investigation of the Accounts, and of the Stock Sheets so far as he can, and if a reasonable and prudent man would have come to the conclusion there was something wrong, that then it is his duty to call the attention of his employers to it, and in that consideration he is entitled to take into account the fact that the documents are vouched by trusted servants of his employers . . . . he is entitled to rely on the honest servants—those believed to be honest—and experienced in the business of the Company whose Accounts he is examining. He is not supposed to be put upon enquiry because a later examination shows that something has gone wrong. . . . "

On the question of the liability of the Auditor for negligence of his clerks, the learned Judge added :—

"I further rule as a guidance to myself, that, with some slight exceptions where judgment and discretion come in, the skill of the clerk must be the same as the skill of the principal. The principal must not excuse himself for his clerk's negligence by saying that he employed a clerk. Of course it must not be understood that I am dealing with a case where judgment has to be given as to whether a thing is to be treated as Capital or Revenue. I am not dealing with questions of judgment, but with questions of fact."

Although the legal liability of the Auditor may thus be defined, nevertheless he should, if anything, rather go beyond the legal limit of his duties, and by making such tests as commend themselves to his discretion satisfy himself as far as he can that the representations made to him are correct.

In the *Bank of Liverpool* case there is no question that the Balance Sheet, as certified by the Auditors, correctly set forth the position of affairs, as shown by the books, but the books themselves were falsified.

As regards the Auditor's position in such a case, the well-known remarks of Lord Justice Lindley in *re London and General Bank, No.* 2 (1895, 2 Ch. 682), may be quoted. His Lordship observed :—

". . . . The Auditor's business is to ascertain and state the true financial position of the Company at the time of the Audit, and his duty is confined to that. But then comes the question, How is he to ascertain such position ? The answer is, By examining the books of the Company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the Company themselves show the Company's true position. He must take reasonable care to ascertain that they do. Unless he does this his duty will be worse than a farce. Assuming the books to be so kept as to show the true position of the Company, the Auditor has to frame a Balance Sheet showing that position according to the books, and to certify that the Balance Sheet presented is correct in that sense. . . . The Auditor, however, is not bound to do more than exercise reasonable care and skill in making the inquiries and investigations. He is not an insurer ; he does not guarantee that the books do correctly show the true position of the Company's affairs. . . His obligation is not so onerous as this. . . . He must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. . . ."

The books of the Bank in question were not so kept as to show the true position of the Company, and the circumstances of the fraud were such that, the Auditors could not reasonably have been held responsible for detecting the fraud. The onus in this case lay entirely upon the Bank themselves, whose duty it was to have had an efficacious system of check in operation against such possibilities.

In the case of the London and Globe the Auditors called for minutes authorising the dealings between the various Companies, and these were produced to them on loose sheets of paper. The consents of the Brokers to transfer the liabilities were promised to them, and they signed the Balance Sheet on the faith of that promise. As a matter of fact, however, those consents never had been, and never were, obtained.

The Auditors' certificate contained the following words :—

" The current financial engagements of the Company appear in the Balance Sheet at the amount expended to the date thereof, and the joint transactions between this Company and its allied Companies, the British America Corporation, Ltd., and the Standard Exploration Company, Ltd., are verified by the minutes

of the Directors and confirmed by the Directors of the allied Companies ; subject thereto, and to the sum written off being adequate in respect of shares held in the allied Companies and various other undertakings, we are of opinion that the Balance Sheet correctly represents the position of the Company's affairs as shown by the books."

When Whitaker Wright saw the clause in the certificate dealing with the transactions of the allied Companies, he said he thought it was unnecessary and might do harm, and asked whether it could not be omitted. The Auditors refused to do so, and stated subsequently that in their opinion the certificate was very strong, and ought to have set any sane man on inquiry. In fact, it teemed with suspicion.

The question as to how far an Auditor is safeguarded by signing a report which should set people on inquiry—that is to say, which conveys to the Shareholders that they ought to ask for further information, but does not itself give them that information—is a very important one, and Lord Justice Lindley refers to this very point in his judgment on the *London General Bank* case. His Lordship said :—

" A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calaulated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. . . . An Auditor who gives shareholders the means of information instead of information in respect of a Company's financial position does so at his peril, and runs the very serious risk of being held judicially to have failed to discharge his duty."

Section 113 of the Companies (Consolidation) Act, 1908, gives the Directors the option of determining whether the Auditors' report shall be printed on the Balance Sheet, or merely a reference to that report made on the face of the Balance Sheet. In any case, the report must be read at the Shareholders' meeting, and is open to the inspection of members, who are also entitled to obtain a copy of the Balance Sheet and the report on payment of the prescribed fee, and means are thus provided in cases where the publication of the report on the face of the Balance Sheet would be detrimental to the Company's interests to enable such report to be made in a manner which shall least conflict with those interests.

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